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C O N F I D E N T I A L SECTION 01 OF 04 ASTANA 000116

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TAGS: [ENRG](#) [EPET](#) [KZ](#) [PGOV](#) [PREL](#)  
SUBJECT: KAZAKHSTAN'S PETROCHEMICAL AMBITIONS:  
FORWARD-THINKING OR FOLLY?

REF: A. 06 ASTANA 737

[1](#)B. 06 ASTANA 738

Classified By: Charge d'Affaires Kevin Milas; reasons 1.4 (b) and (d).

[1](#)1. (C) Summary: The Government of Kazakhstan (GOK) is aggressively encouraging foreign investment in a domestic petrochemical industry as part of its strategy to diversify the economy and to "climb the value chain" of hydrocarbon production. The GOK has authorized a predictable set of tax benefits for petrochemical investors, but the largest incentive to invest may be the 2005 law governing offshore oil contracts, which makes explicit the GOK's intent to favor exploration and production bids from companies which commit to investing in the petrochemical industry. Western oil company executives are uniformly skeptical of the economics of petrochemicals in Kazakhstan, pointing out that the country is disadvantaged, especially in comparison with the Middle East, in terms of feedstock availability, distance to market, and supporting infrastructure. Numerous potential petrochemical projects have been discussed in the media over the last year, but the one which appears to be furthest along -- a plan to build a \$4 billion complex in Atyrau using ethane from the Tengiz field -- does, indeed, appear to be "uneconomic" and dependent on high-level political will to remain on-track. The 2005 law, along with the growing perception that building a petrochemical plant would "please the President," creates an interesting dilemma for Western oil companies which would prefer to focus on producing and transporting crude oil. End summary.

Outlining the GOK's Vision  
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[1](#)2. (C) The development of a petrochemistry industry is, upon first analysis, a logical extension of Kazakhstan's oil extraction-based economy, and evidence suggests that the GOK has entertained the thought for years. ConocoPhillips (CP) Vice President Bill Berry recently told the Ambassador that the GOK had pressured CP to invest in a petrochemical facility in 1997, during discussions surrounding CP's entry into the super-giant Kashagan project. The petrochemical initiative appears to have first gained official status in 2003, with the publication of the Republic's "Industrial and Innovation Development Strategy for 2003-2015." This document singles out petrochemicals as a sector in which Kazakhstan has a likely competitive advantage. (Note: This document, which focuses on the development of competitive, export-oriented non-raw materials production, is often seen as the starting point for Kazakhstan's subsequent "cluster theory" approach to economic diversification. End note.)

The initiative gained further footing with the 2004 publication of a six-year plan for developing a Kazakhstani petrochemical sector. The clearest sign that this has become a GOK priority, however, are 2005 revisions to the offshore oil production law (see para. 7) which made explicit the GOK's intent to favor companies in the bidding process which pledged to invest in petrochemicals. President Nazarbayev touted the petrochemical industry in his 2004 and 2006 annual addresses, but has been relatively low-key in his public approach to the issue. This contrasts, we are told, to his private approach in talking to international oil companies -- on November 19 CP Country Manager Nick Olds told the Ambassador that Nazarbayev had talked to "all the oil companies" about investing in petrochemicals.

13. (C) While Nazarbayev has not made the connection explicit, many observers believe the petrochemical initiative has also gained momentum from the President's drive to make Kazakhstan one of the fifty "most competitive" nations, and the concurrent emphasis on diversifying the economy. (Comment: While petrochemical production would clearly add value to Kazakhstan's gas resources, it would, as a technology-intensive industry, add relatively few jobs. End comment.) Shell's Country Chairman, Martin Ferstl (whose company advised the GOK on a petrochemical strategy in 2005) told Energy Officer recently that he believed Nazarbayev's motivations for promoting the industry were driven in part by fears that, once Kazakhstan joined the WTO, the country would be flooded with Chinese products. Kazakhstan hoped to export petrochemicals to China, Ferstl concluded, in order to help balance trade flows.

14. (C) In 2005 the state-owned Center for Marketing and Analytical Research (CMAR) undertook a feasibility study of the industry, contracting with Nexant to produce a detailed

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"Petrochemical Masterplan," the fundamental conclusions of which -- that an ethane-based petrochemical complex based in Atyrau would have an expected internal rate of return (IRR) of 13-16% -- were presented during a November 2005 petrochemical conference in Astana. (Note: There was widespread skepticism of this IRR figure. Two oil company executives whispered to Energy Officer on the margins of the conference that Nexant had originally returned a much lower IRR -- in the single digits -- only to be told to go back and change the study's assumptions. End note.)

#### Existing Facilities / Planned Future Facilities

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15. (U) In the Soviet era, Kazakhstan's petrochemical industries (a polyethylene plant in Aktau, a polypropylene plant in Atyrau, a tire-manufacturing plant in Shymkent, and a complex of rubber plants in Karaganda) functioned as part of a larger Soviet production chain, importing raw materials from Russia and distributing the resulting value-added products throughout the USSR. While several of the rubber plants have survived since independence by exploiting the same interconnections with the Russian market, the Aktau and Atyrau plants have struggled. Both had shut down prior to being purchased, in 2004, by "Atoll" -- a Kazakhstani joint-venture which, in 2006, joined with Dutch-based Basell to become "Kazakhstan Petrochemical Industries" (KPI). Atoll re-tooled the Aktau plant to begin polystyrene production in September 2005, using feedstock from Russia and selling the resulting plastics inside Kazakhstan (12%), to Russia and the CIS (30-40%), and to China (48-58%).

16. (C) KPI has not restored polypropylene production at the Atyrau facility; this site is now one of several being considered as the location for KPI's planned ethane complex in Atyrau (par. 10). The KPI project is merely one of numerous new potential projects which have been discussed publicly in the past year. At the November 2005 petrochemical conference, then-Energy minister Vladimir

Shkolnik singled out a \$3.6 billion KMG / Lukoil gas chemical complex planned in Kazakhstan, near the North Caspian border with Russia. (Note: This project now seems less likely, with Russia reportedly favoring a Russian landing for the offshore gas. End note.) KMG and Marubeni, a Japanese company, are reportedly developing a feasibility study to explore the possibility of producing benzene at the Atyrau refinery, for use as a feedstock for polystyrene production at the Aktau plant. "GS Caltex," a South Korean company, has reportedly launched a feasibility study (with KMG) for construction of a \$1.5 - \$3 billion plastics plant. On December 15, Iranian Foreign Minister Mottaki was quoted in the press as indicating Iran's interest in building a petrochemical complex in Atyrau. These announced deals and discussions may only scratch the surface of active interest: Michael Sturdivant, an Almaty-based Deloitte tax advisor, told Energy Officer on November 28 that "four or five" companies had recently sought Deloitte's advice on possible petrochemical investments in Kazakhstan.

#### Legal and Financial Promotions

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¶7. (C) Kazakhstan's 2005 law governing offshore oil operations (informally, the "Production Sharing Agreement" law) formalized the GOK's intent to favor international oil companies which invest in petrochemical facilities in Kazakhstan. The law states that, in assigning offshore production and exploration rights, the State will favor proposals which further the development of "high technology" -- of which "petrochemistry" is listed as the highest priority. Prime Minister Akhmetov articulated this connection clearly in his keynote speech at the 2005 petrochemical conference, stating "we will prioritize companies who invest in petrochemicals when signing exploration and production contracts."

¶8. (C) ConocoPhillips' (CP) bid to secure Kazakhstan's offshore "N" block (Ref A) provides one example of how the GOK is implementing this law. CP related to Post that, during CP CEO Jim Mulva's meetings in Astana in May 2006, Prime Minister Akhmetov and other officials told Mulva that the surest way to win a share of the "N" block was to commit to partner with KMG in building a petrochemical facility which would utilize "N" block gas. Akhmetov answered Mulva's skepticism about the commercial feasibility of such a project by referring to Nexant's finding that an ethane cracker

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complex had an expected IRR of 13-16%.

¶9. (SBU) The GOK has also created tax and other financial incentives for petrochemical investment. The 2006 Tax Code (Article 119-1) provides a five-year exemption on corporate income tax for petrochemical projects established from 2004-2007 and meeting minimal investment thresholds. (Note: A local accountant -- and skeptic of the petrochemical sector initiative -- minimized the significance of this article as an incentive to investment, pointing out that an exemption on corporate income tax has value only if the company has taxable profits in the first place. End note.)

¶10. (SBU) Finally, the GOK has launched a feasibility study for the creation of a "National Industrial Petrochemical Technopark" in Atyrau, where investors will enjoy the benefits of operating in a "special economic zone," including exemptions from land and property tax, VAT exemptions on service turnover, and exemptions from customs duties on imported goods. (Note: The "technopark" is a key element in Kazakhstan's "industrial innovation" strategy -- the 2003 initiative at diversifying the economy which gave rise to Kazakhstan's "cluster" approach to diversification.) While the technopark plans feature prominently in the Atyrau oblast's short-term economic development vision, no institutions have yet been built.

## Atyrau Petrochemical Facility

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¶11. (C) The petrochemical project which has received the most press, and appears to be furthest along in development, is KPI's planned \$4 billion ethane-based cracker, an associated LPG-based Propane Dehydrogenation Plant, and downstream polyethylene and polypropylene facilities, based in Atyrau. The project's first stage envisions building a cracker utilizing 3 billion cubic meters (bcm) of gas annually from the nearby Tengiz oil field, and a second complex, further in the future (2013-18), based on gas volumes from the Kashagan field.

¶12. (C) The project still appears to face considerable hurdles despite much forward-leaning press and clear government support. The First Deputy Akim of Atyrau told the DCM on November 28 that the oblast based "many hopes on petrochemicals," and listed development of a petrochemical industry as the oblast's second economic priority, trailing only further development of oil and gas production. Nevertheless, TengizChevrOil (TCO) General Manager Todd Levy recently told DCM (Ref B) that negotiations between KPI and TCO for Tengiz gas supplies were proceeding only because Nazarbayev had asked Chevron Chairman David O'Reilly to support the project. TCO had agreed to supply KPI with below-market gas, Levy said, but even so the project appeared to be "uneconomic," and the deal would likely fail without additional political intervention. Access Industries (parent company of KPI participant Basell) Vice President Paul Rodzianko seemed to have reached the same conclusion when, on December 7, he asked Energy Officer how the Embassy might react to a request from Access to "put some pressure" on TCO to conclude a gas deal. "The project has to happen," Rodzianko explained, "because it's important to Nazarbayev."

¶13. (C) Although KPI recently announced signature of an MOU concerning "mutual intent to proceed with negotiations over gas supplies," with Kashagan operator AGIP KCO, the consortium is not factoring gas supplies for a petrochemical plant into their project development plans. Ferstl told Energy Officer on December 8 that the GOK had recently "seemed to drop" the idea that AGIP KCO should allocate gas for a petrochemical plant; for this and other reasons the consortium had recently adopted a "full re-injection plan" for Kashagan gas. AGIP KCO's Astana Office Manager, Luka Rogoz, confirmed this on December 6, telling Energy Officer that "all" of Kashagan's gas would be re-injected, beginning six months after first commercial oil production. As a consequence, he continued, Kashagan engineering and construction was proceeding on the basis of 100% re-injection. If the GOK came back to the consortium with a request to support the petrochemical industry, he concluded, "I don't have the faintest idea how we would accommodate the request."

## Private Sector Skepticism

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¶14. (C) Among local oil company executives, skepticism of the GOK's petrochemical ambitions run high. The skeptics articulate three primary disadvantages faced by Kazakhstan: lack of available feedstock, distance from market, and inadequate supporting infrastructure. To outline the argument concerning feedstock: seventy percent of Kazakhstan's known gas resides in three fields: Karachaganak, Kashagan, and Tengiz. Karachaganak is reportedly near to signing a long-term deal to supply gas to the Orenburg gas refinery in Russia which would commit the field's gas supplies well into the next decade. Kashagan partners are pursuing full re-injection. While TCO has lower re-injection goals for Tengiz, and the field's high ethane content makes it attractive for use in petrochemical production, two independent industry studies (by Shell and ExxonMobil) have

concluded that Tengiz does not have sufficient gas to drive a cost-competitive cracker. Intertwined with the idea of gas "availability," of course, is the issue of gas economics: how can Kazakhstan's gas -- often highly-sulfurous, and thus expensive to process; and associated with oil, and thus valuable for raising reservoir pressure for high-value oil -- compete with gas from the Middle East which (a) is often found separate from oil; (b) is often "stranded" (or isolated from market), and thus cannot be monetized on its own; and (c) often receives governmental support which lowers the price below export parity?

¶15. (C) In terms of infrastructure, the ExxonMobil study suggests that the "green field" costs for petrochemical development in Kazakhstan are approximately twice that of "brown field" costs on the U.S. Gulf Coast -- a difference which reflects both significantly higher construction costs in cold and isolated Kazakhstan, and the relative lack of surrounding road, port, rail, and electrical infrastructure. This lack of infrastructure exacerbates Kazakhstan's third major disadvantage, that of geography: thousands of miles from either the European or Chinese markets, the country suffers a logistical disadvantage in relation to existing or potential competitors, especially in the Middle East. These disadvantages add up, in ExxonMobil's detailed study, at least, to single-digit returns on investment in petrochemical facilities in Kazakhstan. While the study suggests that the GOK can do much to reduce Kazakhstan's disadvantages -- primarily by investing in infrastructure -- the necessary changes are years, if not decades, away.

¶16. (C) Comment: There is a clear contradiction between the oil companies' calculations that a petrochemical plant in Kazakhstan is not economic, and the GOK's evident will that one (or more) be built. The GOK can, to some extent, improve project economics even further with tax cuts and, in the long term, infrastructure improvements. The 2005 PSA law, of course, broadens the relevant economic calculation, essentially inviting companies to "write off" a low- (or no-) profit petrochemical plant in return for access to a potentially lucrative offshore oil field. And finally, pleasing President Nazarbayev carries benefits that cannot be captured by purely economic models. These reasons appear to explain the private sector interest expressed so far, and will likely, sooner or later, lead to a company taking the petrochemical plunge, if adequate supplies of gas can be secured. These investments will likely occur in partnership with KMG -- which, as a state-owned company, may have the mandate and leeway to undertake "strategic" projects with low expected rates of return. End comment.

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